

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:LM:FS:MAN:2:TL-N-1583-01

JWFogelson

date:

to: Henry V. Singleton, Territory Manager
Territory 1100, Group 1146
Attention: Larry Wolfson, Revenue Agent

from: Area Counsel, LMSB (Financial Services)

subject:

Tax Year

Deductibility of Litigation Settlement Payment made to

U.I.L. Nos. 162.00-00, 162.05-03, 162.05-25, 162.21-00

This memorandum is in response to your request for assistance dated March 1, 2001 in the above-captioned matter regarding whether [REDACTED] may deduct on its tax return for its [REDACTED] tax year the payments it made during that tax year pursuant to a settlement agreement ending the lawsuit brought against it by a former employee, [REDACTED]. This memorandum should not be cited as precedent.

This memorandum is not binding on Examination or Appeals and is not a final case determination. This memorandum is advisory and does not resolve Service position of an issue or provide the basis for closing a case. The determination of the Service in this case is to be through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

May [REDACTED] deduct on its [REDACTED] tax return the payments it made during its [REDACTED] tax year to [REDACTED] and his attorneys in accordance with a settlement agreement ending the lawsuit brought against it by [REDACTED]?

CONCLUSION

[REDACTED] may deduct the payments on its [REDACTED] tax return.

FACTS

In [REDACTED] [REDACTED] who was not of [REDACTED] was hired by a group forming a new [REDACTED] to be based in the [REDACTED] [REDACTED]'s principal shareholder and the Chairman of its Board of Directors was [REDACTED] a [REDACTED]. In [REDACTED] the New York State [REDACTED] Department authorized [REDACTED] to carry on a [REDACTED] business. In [REDACTED] the [REDACTED] opened for business in [REDACTED].

In [REDACTED] while [REDACTED] was on vacation after a period of hospitalization, his employment by [REDACTED] as an [REDACTED] [REDACTED] was terminated by the [REDACTED] without severance pay. In addition, [REDACTED] stopped payment on [REDACTED]'s final paycheck. At the time of his termination, [REDACTED]'s annual salary was \$ [REDACTED] and he was the [REDACTED] paid employee of [REDACTED].

In [REDACTED] [REDACTED]'s attorneys contacted [REDACTED] and [REDACTED] [REDACTED]'s President, alleging that [REDACTED]'s termination violated [REDACTED]'s own by-laws, the [REDACTED]'s agreement with the New York State [REDACTED] Department restricting the [REDACTED]'s ability to change [REDACTED] management without the department's prior approval, and several anti-discrimination provisions of New York State and federal law, including those prohibiting employment discrimination based on age and national origin. In [REDACTED] [REDACTED]'s attorneys again contacted [REDACTED] and [REDACTED] to insist that [REDACTED] [REDACTED], allegedly in violation of several rights and laws including his right to privacy.

In [REDACTED] [REDACTED] filed charges of discrimination related to [REDACTED]'s termination of his employment with the New York State Division of Human Rights and the federal Equal Employment Opportunity Commission (the "Commission"). In [REDACTED] the Commission issued to [REDACTED] a Notice of Right to Sue under Title VII of the Civil Rights Act of 1964 (42 U.S.C. § 2000e et seq.) with regard to discrimination based on national origin. The Notice also noted that [REDACTED] was already entitled to sue under the Age Discrimination in Employment Act of 1967 (29 U.S.C. § 623 et seq.) for alleged age discrimination.

Later during [REDACTED] [REDACTED] filed a complaint in the

United States District Court for the [REDACTED] bringing suit (the "Action") against [REDACTED] and [REDACTED], an attorney who represented [REDACTED] and who allegedly participated in the termination of [REDACTED]'s employment. While we have not reviewed a copy of the complaint commencing the Action, based on a [REDACTED] letter to [REDACTED] from its attorneys, [REDACTED] sought in the complaint [REDACTED]

[REDACTED]

According to memoranda prepared by [REDACTED]'s attorneys, [REDACTED] incurred legal fees and costs of over \$[REDACTED] in defending the Action brought by [REDACTED].

In [REDACTED] years after [REDACTED]'s employment was terminated by [REDACTED], (i) [REDACTED] and (ii) [REDACTED] and [REDACTED] and [REDACTED] (the "[REDACTED] Defendants") entered into a Settlement Agreement and Release (the "Agreement"). In the Agreement, its parties acknowledged that they desired "to settle and terminate, with prejudice, the Action, and all claims, demands, liability or causes of action, if any that do or may exist as of the date hereof against the [REDACTED] Defendants ... or that were or could have been asserted by or on behalf of [REDACTED] in the Action."

Paragraph [REDACTED] of the Agreement provided that [REDACTED] and his attorneys were to receive \$[REDACTED] (the "Settlement Payment"), payable as described in the Agreement, "in full settlement and satisfaction of the Action and all claims, demands, liability or causes of action that were or could have been asserted in the Action or that otherwise may exist as of the date hereof against the [REDACTED] Defendants ..."

Paragraph [REDACTED] of the Agreement further provided that [REDACTED], in consideration of the receipt of the Settlement Payment,

hereby irrevocably, unconditionally and generally releases the [REDACTED] defendants [and their successors] ... , from or in connection with, and hereby waives and/or settles, with prejudice, any and all actions, causes of action, suits, debts, dues, sums of money, accounts controversies, agreements, promises, damages, judgments, executions, or any liability, claims or demands,

known or unknown and of any nature whatsoever, and which [REDACTED] ever had, now has or hereafter can, shall or may have as of the date of this Action, including without limitation, all claims, demands, liability or causes of action that were or could have been asserted in the Action.

Paragraph [REDACTED] of the Agreement further provided that

[s]pecifically, without limitation, the release contained in this paragraph 2 of this Agreement shall include and apply to any rights and/or claims (i) arising under any contract, express or implied, written or oral; (ii) for wrongful dismissal or termination of employment; (iii) arising under any federal, state, local or other statutes, orders, laws, ordinances, regulation or the like, or case law, that related to employment or employment practices and/or, specifically, that prohibit discrimination in employment based upon age, race, religion, sex, national origin, disability or any other unlawful bases, including without limitation, the Civil Rights Act of 1964, as amended, the Civil Rights Act of 1991, as amended, the Civil Rights Acts of 1866 and 1871, as amended, the Age Discrimination in Employment Act of 1967, as amended, the American with Disabilities Act of 1990, as amended, the Family Medical Leave Act of 1993, as amended, the Employee Retirement Income Security Act 1990, as amended, the Workers Adjustment and Relocation Notice Act, as amended, the Fair labor Standards Act, as amended, the Vietnam Era Veterans' Readjustment Assistance Act, as amended, the Equal Pay Act, as amended, and any similar applicable statutes, orders, laws, ordinances, regulations or the like, or case law, of the State of New York, or any political subdivision thereof, and any applicable rules and regulations promulgated pursuant to or concerning any of the foregoing statutes, orders, laws, ordinances, regulations, or the like; (iv) based upon any other federal, state or local statutes, orders, laws, ordinances, regulations, case law or the like; (v) for tort, tortious or

harassing conduct, infliction of mental distress, interference with contract, fraud, libel or slander; and (vi) for damages, including without limitation, punitive or compensatory damages, or attorneys' fees, expenses, costs, wages, injunctive or equitable relief.

Paragraph [REDACTED] of the Agreement provided in part that the Agreement and the Settlement Payment

are not intended to be, and shall not be construed as and are not an admission or concession by any [REDACTED] Defendant] of any wrongdoing or illegal or actionable acts or omissions, and all [REDACTED] Defendants] expressly deny that any of them engaged in any wrongdoing or illegal or actionable acts or omissions.

In accordance with the terms of the Settlement Agreement, during its [REDACTED] tax year [REDACTED] made the payments called for thereunder to [REDACTED] and his attorneys.

DISCUSSION

I.R.C. § 162(a) generally allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. I.R.C. § 162(c) provides that no deduction shall be allowed under section 162(a) for any illegal payment, bribe, kickback, or rebate when made under any of the circumstances described in that subsection. I.R.C. § 162(f) provides that no deduction shall be allowed under § 162(a) "for any fine or similar penalty paid to a government for the violation of any law" and I.R.C. § 162(g) provides that no deduction shall be allowed under § 162(a) for two-thirds of any damages paid by a taxpayer in connection with a criminal antitrust case. I.R.C. § 162(c) was originally enacted by the Technical Amendments Act of 1958, P.L. 85-866, § 5(a), and later substantially amended by § 902 of the Tax Reform Act of 1969, P.L. 91-172. I.R.C. §§ 162(f) and (g) were enacted by § 902 of the Tax Reform Act of 1969.

Application of I.R.C. §§ 162(a) and (c) was addressed in Rev. Rul. 80-211, 1980-2 C.B. 57. This ruling considered whether punitive damages paid by a corporation ("Corporation X") were deductible as ordinary and necessary business expenses under I.R.C. § 162. Corporation X paid the punitive damages as a result of a court judgment in a civil lawsuit brought against it

by another corporation for breach of contract and fraud in connection with the ordinary conduct of Corporation X's business. In applying I.R.C. §§ 162(a) and (c), the revenue ruling noted that "the courts and the Service have recognized that payments made in settlement of lawsuits are deductible if the acts which gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business." Further, the revenue ruling noted that

[t]he Senate Finance Committee in S. Rept 91-522, 91st Cong., 1st Sess. (1969), 1969-3 C.B. 423, 597, stated that the additions to section 162 of the Code made in section 902 of the Tax Reform Act of 1969 ... denying deductions for the following expenditures were intended to be all inclusive (emphasis added in Rev. Rul. 80-211): fines or similar penalties paid to a government for violation of any law, a portion of treble damage payments under the antitrust laws, bribes to public officials, and other unlawful bribes of "kickbacks".

Rev. Rul. 80-221 noted that Corporation X was sued by another corporation for fraudulent acts and contractual violations perpetuated in the ordinary conduct of Corporation X's business activities and therefore the entire judgment paid by Corporation X, including the punitive damages, were ordinary and necessary costs of its doing business. The ruling also noted that the lawsuit against Corporation X was not based upon any of the prohibited activities described in I.R.C. § 162(c) and concluded that the punitive damages were deductible.

Rev. Rul. 74-323, 1974-2 C.B. 40, also supports the conclusion that expenses incurred in the ordinary and necessary conduct of a business, that are otherwise deductible under I.R.C. § 162(a), will only be nondeductible on public policy grounds if they are described in subsections (c), (f) or (g) of I.R.C. § 162. This ruling considered whether an employment agency could deduct under I.R.C. § 162(a) expenses for advertisements, placed in the regular course of its business, that violated § 704(b) of the Civil Rights Act of 1964. The ruling concluded that because neither the Civil Rights Act of 1964 nor any other law of the United States provided for any criminal penalty or the loss of license or privilege to engage in a trade or business for a violation of § 704(b) of the Civil Rights Act, the expenses were deductible notwithstanding that they were illegal under the Act.

Rev. Rul. 74-323 stated that section 902 of the Tax Reform

Act of 1969

amended section 162 of the Code by adding new subsections (c), (f), and (g) dealing with the denial of deductions for payments which are deemed to violate public policy. These provisions deal with four types of expenditures: (1) fines or similar penalties paid to a government for the violation of any law; (2) a portion of treble damage payments under the antitrust laws following a related criminal conviction (or plea of guilty or *nolo contendere*); (3) deductions for bribes paid to public officials; and (4) other unlawful payments including illegal bribes or kickbacks.

The legislative history of section 902 of the Tax Reform Act of 1969 discloses that an expenditure will be nondeductible under section 162 on public policy grounds only if it fits within one of the categories described in section 162(c), (f), or (g) of the Code. S. Rep. No. 91-552, 91st Cong. 1st Sess. 273 (1969), 1969-3 C.B. 423, 597. Thus, section 162(c), (f), and (g) obviates the necessity for determining whether particular trade or business expenditures violate sharply defined public policy by specifically stating what trade or business expenditures are nondeductible. (Emphasis added.)

In the instant case, [REDACTED] paid the Settlement Payment in settlement of the Action brought against it and [REDACTED] and [REDACTED] by [REDACTED]. While [REDACTED] alleged that the [REDACTED] Defendants had violated a host of laws, the primary thrust of the Action appears to have been that [REDACTED] had wrongfully terminated his employment in violation of various laws prohibiting employment discrimination on the grounds of age and national origin. We have not identified any law of the United States that provides for a criminal penalty or the loss of license or privilege to engage in a trade or business as a result of such discrimination. Further, while [REDACTED] also sued [REDACTED] and [REDACTED], the involvement of those persons in the termination of his employment was primarily as agents for [REDACTED]. Finally, [REDACTED]'s determinations to hire and terminate employees, such as [REDACTED], were made in the ordinary course of its trade or business of [REDACTED]. For

these reasons, we conclude that the Settlement Payment arising from the lawsuit involving the termination of [REDACTED]'s employment was an ordinary and necessary expense of [REDACTED]'s business within the meaning of I.R.C. 162(a) and that I.R.C. § 162(c) does not apply to disallow a deduction for the Settlement Payment. Of course, neither I.R.C. §§ 162(f) nor (g) apply to disallow a deduction for the Settlement Payment because the payment was not a fine or similar penalty paid to a government or damages paid in a criminal antitrust case.

This advice relates solely to the facts of this case and should not be used or applied to the facts of any other case. If you have any questions concerning this memorandum, please contact Joseph W. Fogelson at (212) 264-1595, ext. 224.

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By: _____
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